WILEY FRONTIERS IN FINANCE

THE EQUITY RISK PREMIUM

The Long-Run Future of the Stock Market

BRADFORD CORNELL

Chapter 6

The Equity Risk Premium and the Long-Run Outlook for Common Stocks

So that there is no suspense, here is the bottom line: The future will not be as bright as the past. The data of Ibbotson Associates showed that over the period from 1926 to 1997, the average equity risk premium was 7.4% over treasury bonds and 9.2% over treasury bills. Investors cannot reasonably expect equities to produce such large premiums going forward. Instead, premiums are much more likely to be on the order of 300 to 400 basis points lower. Reasonable forward-looking ranges for the future equity risk premium in the long run are 3.5% to 5.5% over treasury bonds and 5.0% to 7.0% over treasury bills.

This relatively pessimistic conclusion is based on two considerations. The first is an overall assessment of the empirical data and theoretical arguments presented in Chapters 1 through 4. The second is the analysis of the level of stock prices presented in Chapter 5. Although forecasting future stock returns, even over the long run, is hazardous at best, when all the evidence is taken into account, the conclusion that the future will be less rosy than the past has strong support.